German Advisory Group Ukraine

NEWSLETTER

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Budget 2017: Continuation of the fiscal consolidation process

The budget for 2017 was adopted on 21 December by parliament. Despite a late and typically emotional adoption of the budget, the whole process came to a good end: the government managed to deliver a budget, which meets the IMF-required deficit of 3% of GDP and is based on realistic revenue and expenditure assumptions.

Expenditure allocation reflects political priorities, with the social sphere, defence and the decentralisation reform marking key elements of the budget. Revenue is expected to grow by 20% compared to 2016. Whilst VAT remains the biggest contributor to revenue collection, excise duties have been increased. The two-fold hike of the minimum wage will increase the public sector wage bill, but measures have been taken to contain this effect. Higher pay for a large group of public employees with lower incomes is also expected to stimulate consumption and, therefore, increase VAT collection.

Public debt has reached about 85% of GDP in late 2016 and is expected to stay flat at this level over 2017. A major factor was the issuing of government bonds to recapitalise Privatbank, which was nationalised in late 2016.

The process of adopting the budget

Unlike in most of the previous years, the government had prepared the draft budget for 2017 in accordance with the deadlines set by legislation. The draft, which was approved by the Cabinet of Ministers on 15 September, was developed by the Ministry of Finance on the basis of realistic forecasts of revenues and expenditures – instead of expenditure propositions by line ministries. Other remarkable improvements include consultations with independent experts on the revenue forecast, a comprehensive and transparent publication of the draft budget bill and the 3-year planning that was developed and presented as additional information together with the draft budget. The budget passed the first hearing in parliament on 20 October.

What had started in a promising way of developing the 2017 budget in line with good international practice has then experienced some of the features which have become almost typical for the budget process in Ukraine over the past years. Several budget-relevant decisions have been taken in the period between the first and the second hearing in parliament. The minimum wage has increased two-fold and other legislation has been amended so that the legal grounds for some budget estimates were no longer valid. The fiscal implications of the recent nationalisation of the country's biggest financial institution, Privatbank, have led to a much more emotional debate of the nation's budget bill in the second hearing. The budget for 2017 has ultimately been adopted in the small hours of 21 December.

Key parameters of the budget

The budget is based on 3% real GDP growth, which is a realistic assumption if the reform process continues. Inflation is forecast at 8.1%, the exchange rate at an average of 27.2 UAH/USD. Nominal GDP will rise to UAH 2,585 bn compared to UAH 2,262 bn in 2016. The significant increase of the official monthly minimum wage from UAH 1,600 to UAH 3,200 (equivalent to 120 USD) is taken into account in the budget.

State budget (central government)

	UAH bn	% of GDP
Revenues	731	28.3
Expenditures*	809	31.3
Balance	-78	-3.0

*Source: Parliament of Ukraine, * including net credits*

Revenues

Overall, revenues are set to increase by 20% over the previous year, which is slightly higher than nominal GDP growth (14%). The government expects the increased minimum wage to result in growing tax and social security revenues, as a result of a de-shadowing of previously undeclared wage income and increased consumption.

With 40% of total revenues, VAT is the most important tax. Among other things, VAT revenues benefit from the full elimination of the special VAT regime for agricultural companies. VAT revenues are followed by personal income tax (17%) and excise duties (16%). The latter have been hiked as part of changes to the Tax Code (the "tax reform law"), e.g. for alcohol and tobacco. Further changes to the Tax Code relate to improvements in VAT administration, which will positively impact the VAT refund process.

Expenditures

Budget expenditures in 2017 are planned to increase by 17% compared to the 2016 plan. The ratio of (central) government expenditure to GDP in 2017 is 31.3%, compared to 30.6% in 2016. The increase will be financed by the increase in revenues.

Transfers to the Pension Fund, debt servicing and defence represent the biggest spending-items (ca 17.5%, 13.8%, 8.0% of total expenditure, respectively). Expenditures have been allocated to reflect political priorities, which is a novelty in the country's budget process. The reform with the largest impact on the budget is the decentralisation reform. Transfers to local governments have been substantially increased compared to last year's budget. These transfers shall be used to finance the increased wage bill for public sector employees in public health and education, the majority of which is delivered by local governments. In addition to salaries, a smaller share of these transfers is available for social and economic development measures at the local level. To contain the rise of the public sector wage bill, the public pay scale has been de-coupled from the minimum wage, resulting in lower salary increases for higher-paid staff. Financing for recently established government institutions (e.g., anti-corruption agencies), or institutions which are to be created in 2017 as a result of ongoing reforms (e.g., Energy Efficiency Fund), is provided for by the budget.

Deficit and public debt

A very important feature of the budget is the planned deficit of 3.0% of GDP (excluding bank recapitalisation), which is in line with the provisions of the IMF programme. This positively compares with the (planned) deficit of 3.7% of GDP in 2016 and marks a continuation of the fiscal consolidation process. For the next two years, the Ministry of Finance foresees a further reduction of the deficit to 2.5% (2018) and 2.3% of GDP (2019).

The deficit will be financed mainly by means of debt issuance. The privatisation target is similar to last year's (UAH 17 bn), which remains ambitious. In 2016, the target was gravely missed; achieved were only about 2% of the planned amount. Against this backdrop changes can be expected. Thus, gross debt issuance is planned at a level of UAH 191 bn (USD 7 bn) this year, with UAH 104 bn domestic issuance and UAH 87 bn foreign issuance. Ukraine plans to tap the Eurobond market in 2017 for the first time in many years; it remains to be seen if this plan can be realised.

The level of public debt to GDP has been affected by the nationalisation of Privatbank, as the Ministry of Finance issued recently UAH 107 bn (USD 4 bn, about 4.7% of GDP) of domestic government bonds to recapitalise the bank. This will increase the level of public debt at the end of 2016. While final figures are not yet available, the public debt to GDP ratio has reached about 85% and will most probably stay flat over this year.

Conclusions

The adoption of the 2017 budget is in several aspects a positive achievement. The budget is based on generally realistic assumptions for revenue collection, and it allocates expenditures to be in line with this revenue. The deficit target of 3% of GDP means that the fiscal consolidation process is firmly on track. For comparison: In 2014, the overall public deficit (including Naftogaz) was at a level of 11.3%. Few countries have made similar progress over such a short period of time.

The IMF-compatible deficit target, together with the recent nationalisation of Privatbank (which the international financial institutions supported publicly), are signs that the authorities are moving closer to the completion of another review of the IMF programme over the next months, which would lead to the release of another loan tranche.

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German Advisory Group

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